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IN THE

Supreme Court of the United States

OCTOBER TERM, 1955

No. 617

L & M REALTY CORPORATION,
A Virginia Corporation, Alleged Bankrupt,
Petitioner

v.

RENA C. LEO, Executrix of the Estate
of Dr. Louis S. Leo, Deceased,
Petitioning Creditor,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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SUBJECT INDEX

	Page
CITATIONS TO OPINIONS BELOW	2
JURISDICTION	2
QUESTION PRESENTED FOR REVIEW	2
STATUTE INVOLVED	2
STATEMENT OF THE CASE	3
REASONS FOR ALLOWING THE WRIT	5
CONCLUSION	10

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TABLE OF CASES

Page

American Surety Co. v. Electric Co., 296 US 133 8

American Surety Co. v. Sampsell, 327 US 269 8

Doyle v. Milwaukee National Bank of Wisconsin, 116 Fed. 295 5

In re Harpke, et al, 116 Fed. 295 5

Jenkins v. National Surety Co., 277 US 258 8

Livingstone v. Heineman, 120 Fed. 786 5

Pepper v. Litton, 308 US 295 7

Swartz v. Fourth National Bank, 117 Fed. 1 5

STATUTES CITED

11 U. S. Code 96(a) (1) 2

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L & M Realty Corporation, a Virginia Corporation, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fourth Circuit, entered in the above-entitled case on December 6, 1955.

CITATIONS TO OPINIONS BELOW

The memorandum opinion of the Referee In Bankruptcy is unreported and is printed in Appendix B hereto, infra page 8. The opinion of the District Court printed in Appendix B hereto, infra page 1 is reported in 131 Fed. Supp. 57. The opinion of the Circuit Court of Appeals, printed in Appendix A hereto, infra page 1 has not yet been reported.

JURISDICTION

The judgment or decree of the Circuit Court of Appeals was entered on December 6, 1955. (Appendix A, page 1.)

The jurisdiction of this Court is invoked under 28 U. S. Code, Section 1254(1).

QUESTION PRESENTED FOR REVIEW

Do payments by a close corporation, composed of only two stockholders, to two banks, who are the only creditors of the corporation (except for advances to the corporation made by those same two stockholders) of notes made by said Corporation payable to said banks, bearing the endorsements of both stockholders, constitute a preference under 11 USC 96 (a) (1) justifying the maintenance of a petition in involuntary bankruptcy by one of said stockholders, where such payments to the banks leave the Corporation without funds sufficient to pay the endorsing stockholders the amount of their advances?

STATUTE INVOLVED

The statutory provision involved in this case appears in 11 USC 96 (a) (1) and is as follows:

"(a) (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor, for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class."

STATEMENT OF THE CASE

L & M Realty Corporation is a Virginia Corporation, composed of only two stockholders, Dr. Louis S. Leo, who died on March 17, 1954, and Dr. Edward Myers. On or about August 12, 1954, the Corporation paid the National Bank of Commerce of Norfolk, at Norfolk, Virginia, the sum of $9,000.00 and interest, due by it to said bank on a note endorsed by both stockholders, and also paid the Seaboard Citizens National Bank of Norfolk, Virginia, the sum of $5,000.00 plus interest due by it to said bank on a note likewise endorsed by both stockholders. These two banks were the only creditors of the corporation, except for the fact that Dr. Leo and Dr. Myers had each advanced the corporation approximately $17,000.00, which advances had not been repaid as of August 12, 1954. The payments to the banks admittedly left the corporation without funds to repay the stockholders for their advances.

On August 16, 1954, Dr. Leo's personal representative filed a petition in involuntary bankruptcy claiming that the payments to the banks created a preference, enabling the banks to obtain a greater per-

centage of the respective debts due them than other creditors of the same class.

The corporation thereupon filed its answer setting up ten defenses to the petition, only one of which was considered by the Referee to whom the cause was referred, namely the Fourth Defense which denied that the payments constituted a preference whereby said banks obtained a greater percentage of the debts due them than other creditors of the same class.

On November 4, 1954, the Referee sustained the Fourth Defense and dismissed the petition.

On November 24, 1954, a petition for review was filed in the United States District Court for the Eastern District of Virginia.

On May 5, 1955, the Honorable Walter Hoffman, Judge of said latter Court, handed down an opinion affirming the judgment of the Referee and dismissing the petition in involuntary bankruptcy on the ground that the payments to the two banks did not create a preference as to the two stockholders.

The case was appealed to the United States Court of Appeals for the Fourth Circuit, at Richmond, Virginia.

On December 6, 1955, said Circuit Court of Appeals in a split decision reversed the lower court and held that the payments to the banks constituted a preference as to the two remaining stockholders, the Honorable Judge Soper dissenting.

The basis for Federal jurisdiction in the court of first instance was the Bankruptcy Act.

REASONS FOR ALLOWING THE WRIT

1. The decision of the Fourth Circuit in the instant case is in direct conflict with the decision of the Seventh Circuit in the case entitled Doyle v. Milwaukee National Bank of Wisconsin, In re Harpke et al., 116 Fed. 295. In that case a bank held two notes of the same maker, one being secured by an endorser. The endorser paid the note on which he was liable with money supplied by the maker. Within four months thereafter the maker was adjudged a bankrupt and in fact was insolvent when the first note was paid. In this case it was held that such payment was not a preference which the bank must surrender as a condition precedent to the proving of the second note against the bankrupt's estate, since the effect of its enforcement would not be to enable the bank to obtain a greater percentage of its debt than other creditors of the same class.

Since the Harpke case, Swartz v. Fourth National Bank, 117 Fed. 1 (8th Circuit) and Livingstone v. Heineman, 120 Fed. 786 (6th Circuit) were decided. These two circuits refused to follow the Harpke case, supra, and repudiated the doctrine there enunciated.

2. The Fourth Circuit in the case at bar, in apparently following the decision of Swartz v. Fourth National Bank, supra, refused to follow the principles laid down in that case, which are pertinent to the case at bar.

In the Swartz case, at page 12, appears the following statement of law applicable to the instant case:

> "The contract of Siegel and Bro. (the endorsers) shows that they would pay these notes if the bankrupt did not. By that contract they were estopped from collecting or receiving anything

upon or account of them from the bankrupt estate, which still owes the full amount of them, until the bank has received the $14,600.00 still due it on the notes."

This statement of law applied to the case at bar. Yet the Fourth Circuit in this case refused to follow the doctrine of estoppel laid down in the Swartz case.

In the case at bar, Dr. Leo and Dr. Myers were endorsers on the notes due to and paid to the banks. By their contract of endorsement they in effect stated to the banks that they would pay the notes if the corporation could or did not do so. The banks were not looking alone to the corporation for they obviously would not have made the loans to the corporation without the added security of the endorsements. Under these facts, are not the endorsers estopped to assert that they are entitled to share equally with the banks, on a debt which they agreed to pay if the corporation did not pay? By failing to follow the Swartz case in this particular, a conflict between Circuit Courts has been created and should be resolved by this Honorable Court.

3. Clearly the question presented by this case is, while novel among reported cases, of importance to the administration of the Federal Bankruptcy laws. The Supreme Court of the United States has not to date handed down a single decision which we could find defining a "creditor of the same class" as set out in 11 USC 96 (a) (1), or what constitutes a payment enabling a creditor to obtain a greater percentage of the debt due him than other creditors of the same class.

Most corporations in existence today are close corporations. They are formed daily by the hundreds. In practically every instance, the stockholders invest

small amounts in capital and treat the rest of their investment as loans to the corporation, in order to obtain a tax advantage through the siphoning off of profits as interest on loans, and in order to share with other creditors in the event of bankruptcy or insolvency. Recognizing this, the Federal Government passed a law dealing with thinly capitalized corporations, and this Honorable Court laid down certain equitable principles hereinafter referred to, subordinating the claims of stockholders in close corporations to those of other creditors. The practice none the less persists, and in all such close corporations loans are obtained from banks, and invariably the banks require the stockholders and officers to endorse the notes of the corporation involved. Therefore, settlement of the question presented by this petition is obviously in the public interest, since it is likely to be presented in almost every bankruptcy proceeding affecting closely held corporations.

4. The decision of the Court below is believed to be erroneous and conflicts with the salutary principles of law, laid down by this Honorable Court in the case of Pepper v. Litton, 308 U. S. 295; 60 S. Ct. 238, 84 L. Ed. 281. At page 304, this Honorable Court had this to say:

> "Consequently this Court has held that for many purposes 'Courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.' Local Loan Co. v. Hunt, 292 U. S. 234, 240. . . .
>
> "The bankruptcy courts have exercised these equitable powers in passing on a wide range of problems arising out of the administration of bankrupt estates. They have been invoked to the end that fraud will not prevail, that substance will not

give way to form, that technical considerations will not prevent substantial justice from being done. By reason of the express provisions of Section 2, these equitable powers are to be exercised on the allowance of claims, a conclusion which is fortified by Section 57(k). For certainly, if as provided in the latter section, a claim which has been allowed, may be later rejected in whole or in part, according to the equities of the case, *disallowance or subordination in light of equitable consideration may originally be made* (Italics supplied).

"That equitable power also exists in passing on claims presented by an officer, director or stockholder in the bankruptcy proceedings of his corporation. The mere fact that an officer, director or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it 'pari passu' treatment with the claims of other creditors."

5. The majority decision of the court below conflicts with the equitable principles laid down by this Honorable Court in the following cases:

American Surety Co. v. Electric Co.	296 US 133
American Surety Co. v. Sampsell	327 US 269
Jenkins v. National Surety Co.	277 US 258

That equitable principle is that a surety has no right to share in a bankrupt's estate on equal terms with a creditor whom the surety has undertaken to secure.

The majority opinion in the case at bar overlooks completely the equitable principles referred to and adopt "a lien" theory repugnant to the equitable principles which of necessity apply to all bankruptcy proceedings. The majority of the court ruled that the

endorsers had no lien or priority upon the assets of the bankrupt by virtue of their endorsement, and therefore they stand in the same class as the banks. However, this Honorable Court has held that principles of equity apply to bankruptcy proceedings. Applying equitable principles to the case at bar, we must conclude that it is grossly inequitable to permit the endorsers on notes due the banks to share pro-rata with the banks, and leave the banks the task of proceeding against the individual estates of the endorsers. If both individual estates were insolvent and heavily indebted on preferred and secured claims, then it is obvious that the banks would be left unpaid despite the precautions they took to protect their claims by insisting upon personal endorsements at the time the loans were made.

The majority opinion seeks to protect creditors of a stockholder. The sole purpose of 11 USC 96 (a) was to prevent a creditor in these proceedings from obtaining a greater percentage of his debt than some other creditor in the same proceeding who is in the same class. It was not designed to protect individual creditors of a creditor in a bankruptcy proceeding.

As Judge Soper eloquently stated in his dissenting opinion set out in the appendix of this petition:

> "It is conceded in the opposing argument that if Leo's estate were solvent, the payments to the banks would not have prejudiced the other two creditors because each of them would have been relieved of his obligation as endorser. This is true, but it is also conclusive of the whole controversy. It is manifest that Leo, insolvent, had no greater claim against the corporation than Leo, solvent, would have had. Undoubtedly the effect of the payments to the banks was to deprive Leo's creditors of a share of the assets of the bankrupt corporation,

but Leo's creditors had no greater right to object than Leo himself. The argument confuses the creditors of Leo with the creditors of the bankrupt corporation. The section of the bankruptcy act which defines the preferential transfer of the property of an insolvent is designed to protect *his* creditors; but is not concerned with the creditors of his creditors."

CONCLUSION

For the foregoing reasons this petition for a writ of certiorari should be granted.

Respectfully submitted,

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Counsel for Petitioner

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I, Samuel Goldblatt, of Counsel for Respondent, do hereby acknowledge that a copy of the foregoing petition for a writ of certiorari was duly served upon me by delivery of the same to me by Counsel for Petitioner this 6th day of January, 1956.

SAMUEL GOLDBLATT

of Counsel for Respondent